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## Has Expungement Broken BrokerCheck?

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# HAS EXPUNGEMENT BROKEN BROKERCHECK?<sup>1</sup>

*Christine Lazaro*<sup>2</sup>

I. HISTORY OF EXPUNGEMENT .....	124
A. The Regulatory Environment .....	124
B. The Central Registration Depository .....	125
C. The BrokerCheck System .....	128
D. Expungement of Information from the CRD and BrokerCheck ..	129
II. EXPUNGEMENT & SETTLEMENT .....	134
A. Customer Affidavits .....	134
B. Arbitrator Findings .....	135
III. PUBLIC INTEREST CONCERNS .....	137
A. State Regulator Intervention .....	137
a. <i>Maryland</i> .....	138
b. <i>New York</i> .....	139
B. PIABA's Expungement Study .....	144
IV. RECOMMENDATIONS FOR CHANGE AND CONCLUDING REMARKS.....	146

Stockbrokers are subject to a comprehensive system of regulation, which was implemented at the federal level after the Great Depression. In creating it, Congress sought to re-establish investor trust in the marketplace by mandating the disclosure of material facts about investment opportunities. Today, the securities laws also call for public disclosure of information about brokers so that the public may assess whether to do business with a particular broker.

Brokers have broad disclosure obligations and, unlike most other occupations, these obligations require the disclosure of even mere allegations of wrongdoing against a broker. Despite this, recent evidence indicates that the disclosures may be subverted by the systemic expungement of customer complaints from the broker's public record. Indeed, a troublingly high percentage of brokers have been able to obtain arbitrator recommendations of expungement of customer complaints from

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1. The author wishes to thank Benjamin P. Edwards, *Adjunct Professor of Law and Director of the Investor Advocacy Clinic at Michigan State University College of Law*, and Francis J. Facciolo, *Professor of Legal Writing and Assistant Director of the Securities Arbitration Clinic at St. John's University School of Law* for their helpful comments on this paper, and Alec Coquin, *St. John's University School of Law* ('14), for his help with citation.

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their records. This raises questions about whether the current system adequately meets these disclosure goals.

This Essay primarily explores the rules and processes governing the public reporting of customer complaints against brokers and the methods by which these complaints have been expunged from public records. To contextualize the issues, Section I provides an overview of the somewhat unique regulatory environment governing brokers and traces the history of efforts to provide accurate information about brokers. Section II discusses more recent difficulties with public disclosures and presents the rules and procedures which allow for expungement of customer complaints from a broker's public record. Section III highlights public interest concerns with the process, primarily the difficulties state regulators have experienced when attempting to preserve the integrity of their records as well as the results of a recent study showing the flaws within the process when expungement requests are handled within the arbitration process. To improve the information available to the public, this Essay suggests reasonable changes that would make the system more robust and more difficult to game.

## I. HISTORY OF EXPUNGEMENT

### A. The Regulatory Environment

Brokers are governed by a unique regulatory framework, subject to both extensive state and federal statutory and regulatory regimes. The vast bulk of federal regulation and oversight of brokers and brokerage firms has been delegated to FINRA, the Financial Industry Regulatory Authority, a self-regulatory organization with the power to govern its members' conduct. FINRA operates under the oversight of the Securities and Exchange Commission ("SEC"), a federal agency established by the federal securities laws.

FINRA was created on July 26, 2007 through the consolidation of the National Association of Securities Dealers ("NASD") and the member regulation, enforcement and arbitration operations of the New York Stock Exchange.<sup>3</sup> Because these two different self-regulatory organizations had different rulebooks, FINRA has been gradually consolidating its rules into a single, governing FINRA rulebook.<sup>4</sup> FINRA has established rules governing the conduct of brokers and brokerage firms.

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3. For ease of reference, this article generally refers to the NASD as FINRA throughout unless the context requires otherwise.

4. This process has not yet been completed. Accordingly, FINRA maintains three rulebooks: FINRA Rules, NASD Rules and NYSE Rules. As NASD and NYSE Rules are consolidated, they are given FINRA Rule numbers and are then retired.

FINRA also provides an arbitration forum to resolve customer disputes, disputes between broker-dealer firms, and disputes between brokers and their firms. Notably, nearly every account opening agreement contains a pre-dispute arbitration clause requiring customers to submit disputes that may arise between them and their broker or brokerage firm to FINRA.

Arbitration differs from cases filed in court in a number of respects, but importantly, arbitration diminishes the amount of public information available about disputes. Documents filed in arbitration are not public records and customers seeking information about a broker may not access papers filed in arbitration proceedings. Without disclosures from FINRA, customers would not be able to determine whether other customers had filed complaints about a particular broker or, if such complaints had been filed, how many there are. As such, public disclosures take on heightened importance.

#### B. The Central Registration Depository

Information about brokers comes from a national records database known as the Central Registration Depository (“CRD”). FINRA and the North American Securities Administrators Association (“NASAA”)<sup>5</sup> jointly developed and implemented the CRD database in 1981. It “consolidated a multiple paper-based state licensing and regulatory process into a single, nationwide computer system . . . [i]ts computerized database contains the licensing and disciplinary histories on more than 650,000 securities professionals and 5,200 securities firms”<sup>6</sup> and is used by brokerage firms, regulators, and self-regulatory organizations.<sup>7</sup> Today, “FINRA operates the CRD system pursuant to policies developed jointly with NASAA.”<sup>8</sup> FINRA has worked with NASAA, the SEC, brokerage firms and other members of the regulatory community to “establish policies and procedures reasonably

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5. “Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.” *About Us*, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, <http://www.nasaa.org/about-us/> (last visited Feb. 3, 2014).

6. *CRD & IARD*, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, <http://www.nasaa.org/industry-resources/investment-advisers/crd-iard/> (last visited Feb. 3, 2014).

7. Order Approving a Proposed Rule Change Amending the Codes of Arbitration Procedure, Exchange Act Release No. 58,886, 94 SEC Docket 1445, at 1 n. 8 (Oct. 30, 2008).

8. *Id.* at 2.

designed to ensure that information submitted to and maintained in the CRD is accurate and complete.”<sup>9</sup>

Much of the CRD’s information comes from brokers’ registration forms. When a broker first becomes registered with FINRA, he completes a Form U4, the Uniform Application for Securities Industry Registration or Transfer. Additionally, a broker completes a Form U4 whenever he becomes registered with a new brokerage firm, i.e., when he changes employment. Brokers have an ongoing duty to amend and update the information contained within the Form U4 as changes occur.<sup>10</sup> The Form U4 contains certain disclosure questions which require detailed answers. Question 14I is entitled “Customer Complaint/Arbitration/Civil Litigation Disclosure,” and requires the broker to answer the following questions about customer complaints:

- (1) Have you ever been named as a respondent/defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that you were involved in one or more sales practice violations and which:
  - (a) is still pending, or;
  - (b) resulted in an arbitration award or civil judgment against you, regardless of amount, or;
  - (c) was settled, prior to 05/18/2009, for an amount of \$10,000 or more, or;
  - (d) was settled, on or after 05/18/2009, for an amount of \$15,000 or more?
- (2) Have you ever been the subject of an investment-related, consumer-initiated (written or oral) complaint, which alleged that you were involved in one or more sales practice violations, and which:
  - (a) was settled, prior to 05/18/2009, for an amount of \$10,000 or more, or;
  - (b) was settled, on or after 05/18/2009, for an amount of \$15,000 or more?
- (3) Within the past twenty four (24) months, have you been the subject of an investment-related, consumer-initiated, written complaint, not otherwise reported under question 14I(2) above, which:
  - (a) alleged that you were involved in one or more sales practice violations and contained a claim for compensatory damages of \$5,000 or more (if no damage amount is alleged, the complaint must be reported unless the firm has made a good faith determination that the damages from the alleged conduct would be less than \$5,000), or;
  - (b) alleged that you were involved in forgery, theft, misappropriation or conversion of funds or securities?

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9. *Id.*

10. *Form U4 Uniform Application for Securities Industry Registration of Transfer Instructions*, FINRA (May 2009), <http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015111.pdf>.

Answer questions (4) and (5) below only for arbitration claims or civil litigation filed on or after 05/18/2009.

(4) Have you ever been the subject of an investment-related, consumer-initiated arbitration claim or civil litigation which alleged that you were involved in one or more sales practice violations, and which:

(a) was settled for an amount of \$15,000 or more, or;

(b) resulted in an arbitration award or civil judgment against any named respondent(s)/defendant(s), regardless of amount?

(5) Within the past twenty four (24) months, have you been the subject of an investment-related, consumer-initiated arbitration claim or civil litigation not otherwise reported under question 14I(4) above, which:

(a) alleged that you were involved in one or more sales practice violations and contained a claim for compensatory damages of \$5,000 or more (if no damage amount is alleged, the arbitration claim or civil litigation must be reported unless the firm has made a good faith determination that the damages from the alleged conduct would be less than \$5,000), or;

(b) alleged that you were involved in forgery, theft, misappropriation or conversion of funds or securities?<sup>11</sup>

The question requires detailed disclosure of investment-related, consumer-initiated arbitrations regardless of whether the broker has been named as a respondent in the proceeding. It seeks to uncover any allegations that the broker was involved in sales practice violations, forgery, theft, misappropriation or conversion of funds or securities. If the broker has been named as a respondent in arbitration, it must be disclosed—unless the broker is found not liable or the case is settled for less than \$15,000.<sup>12</sup> If the broker is not a named party in the arbitration, the details of the arbitration remain disclosed under subquestion (4) if the case settles for \$15,000 or more or there has been an arbitration award against one of the named respondents. Under subquestion (5), unless the conditions set forth in subquestion (4) are met, the details of the arbitration must be disclosed for a period of 24 months.

Information gathered on the Form U4 appears within the CRD. Certain information that has been disclosed on the Form U4 is then made available to the public through FINRA's BrokerCheck system.

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11. *Uniform Application for Securities Industry Application or Transfer*, FINRA (May 2009), <http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015112.pdf>.

12. Note that the settlement reporting amount was revised in 2009, at which point it was increased from \$10,000 to \$15,000. FINRA, Regulatory Notice 09-23, 2009 WL 1427510, at 1 (May 15, 2009), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/pl18705.pdf>.

### C. The BrokerCheck System

Today, the public may access information about brokers through FINRA's BrokerCheck system, an internet portal which provides the public with access to only some of the information contained in the CRD database. BrokerCheck provides information about "approximately 1.3 million current and former FINRA-registered brokers and 17,400 current and former FINRA-registered brokerage firms."<sup>13</sup>

Before BrokerCheck existed, FINRA provided information through the Public Disclosure Program. FINRA began the Public Disclosure Program in 1988 in response to written inquiries from the public about brokers' disciplinary histories.<sup>14</sup> FINRA established the Public Disclosure Program "to permit members of the public to have access to information that will help them to determine whether or not to conduct, or continue to conduct, business" with a broker or brokerage firm.<sup>15</sup> It was created about a year after Black Monday and the 1987 stock market crash during a time when investors had lost confidence in the markets and had problem with their brokers.<sup>16</sup> At the same time, NASAA established a toll-free number that investors could call to get information about their brokers.<sup>17</sup> Shortly thereafter, Congress passed legislation requiring FINRA to establish a toll-free number to respond to inquiries about brokers and brokerage firms.<sup>18</sup> In response, FINRA amended its rules to provide for the dissemination of information in response to both written requests and telephonic requests.<sup>19</sup>

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13. *FINRA BrokerCheck- Research Brokers, Brokerage Firms, Investment Adviser Representatives and Investment Adviser Firms*, FINRA, ToolsChttp://www.finra.org/Investors/Calculators/BrokerCheck/ (last visited Feb. 3, 2014).

14. See GAO Letter Report, NASD Telephone Hotline: Enhancements Could Help Investors Be Better Informed About Brokers' Disciplinary Records, at 5 (August 1996), available at <http://www.gao.gov/assets/230/223082.pdf>. At the time, FINRA had amended Article V, Section I of the NASD Rules of Fair Practice, "Notice to Membership and Press of Suspensions, Expulsions, Revocations, and Monetary Sanctions." See Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc., Exchange Act Release No. 25,604, 53 Fed. Reg. 14878 (Apr. 20, 1988).

15. See Exchange Act Release No. 25,604, at 14,878.

16. Nathaniel C. Nash, *Many Black Monday Cases Unheard*, N.Y. TIMES, Oct. 10, 1988, <http://www.nytimes.com/1988/10/10/business/many-black-monday-cases-unheard.html>.

17. NASAA Comment Letter from Christine Bruenn, 2003 President of NASAA, to Barbara Sweeney, Office of Corporate Secretary, NASD, in response to NASD Notice to Members 02-74, at 1 n.1, (Jan. 6, 2003), available at <http://www.nasaa.org/wp-content/uploads/2011/07/87-NASDPublicInformationReview.37627-43960.pdf>.

18. NASD Notice to Members 02-74, 2002 WL 31425766 (Oct. 29, 2002), available at <http://www.finra.org/Industry/Regulation/Notices/2002/p003440>.

19. See Order Granting Accelerated Approval of Proposed Rule Change, Exchange Act Release No. 32,568, 54 SEC Docket 957, at 2 (July 8, 1993).

In 1993, FINRA began to include information about arbitration decisions in the information it made available to the public.<sup>20</sup>

Over time, the federal legislation has evolved so that it now requires FINRA to maintain both a toll-free number and a “readily accessible electronic or other process” to respond to inquiries about brokers.<sup>21</sup> In 1998, FINRA began to make certain information available online through its website<sup>22</sup> and BrokerCheck was created.<sup>23</sup> BrokerCheck disclosures are governed not only by federal legislation but also by FINRA Rule 8312, which requires FINRA to make information available about a broker’s current registrations, as well as summary information about arbitration awards, information about customer complaints and arbitrations that have settled and information about the exams the broker has passed.

#### D. Expungement of Information from the CRD and BrokerCheck

Because BrokerCheck’s disclosures come from the CRD database, its utility may be diminished by anything that reduces or pollutes the information within CRD database. To address possibly inaccurate information that may appear within BrokerCheck, Congress authorized FINRA to adopt rules establishing a process for brokers to dispute the accuracy of information maintained in the CRD that is provided in response to public inquiries.<sup>24</sup> FINRA has established this process within Rule 8312(e).

A broker may dispute the accuracy of information pursuant to Rule 8312(e) by providing written notice to FINRA identifying the inaccurate information, and explaining the reason the information is inaccurate. FINRA will then investigate the claim of inaccuracy and make a determination. If FINRA determines the information is inaccurate, it will modify or remove the information from the CRD, as appropriate.

In addition to disputing the accuracy of information provided by BrokerCheck through the administrative process, a broker may also seek to

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20. *Id.* at 2.

21. *See* 15 U.S.C. § 78o-3(i) (2013).

22. *See* Order Approving a Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Amended Interpretation of IM-8310-2 Concerning the Release of Additional Disciplinary Information, Exchange Act Release No. 39,562, 66 SEC Docket 722 (January 20, 1998).

23. Initially, BrokerCheck was called the Public Disclosure Program. In 2003, FINRA renamed the program “NASD BrokerCheck.” Notice of Filing of Amendment Nos. 4 and 5 to the Proposed Rule Change Relating to the Release of Information Through NASD BrokerCheck, Exchange Act Release No. 54,053, 88 SEC Docket 958, at 1 n.6 (June 27, 2006).

24. 15 U.S.C. § 78o-3(i)(3) (2010).



expunge customer dispute information<sup>25</sup> from the CRD system through court or the arbitration process.<sup>26</sup> Since the inception of the CRD system in 1981, FINRA has expunged customer dispute information from the CRD system when a court order has directed it to do so. For some time, it had also honored *arbitrator*-ordered expungement of customer dispute information from the CRD system. However, in January 1999, after consultation with NASAA, FINRA imposed a moratorium on arbitrator-ordered expungements<sup>27</sup> of customer dispute information because NASAA took the position that the CRD system contained state records and that state records could only be properly expunged with a court order.<sup>28</sup>

NASAA plays an important role in the administration of the CRD system. As discussed above, FINRA operates the CRD system pursuant to policies developed jointly with NASAA.<sup>29</sup> Moreover, NASAA and FINRA are both parties to the CRD Agreement, which states that “data on CRD Uniform Forms filed with the CRD shall be deemed to have been filed with each CRD State in which the applicant seeks to be licensed and with [FINRA] and *shall be the joint property of the applicant, [FINRA], and those CRD States.*”<sup>30</sup> State laws generally do not permit information to be expunged once it has been filed on the CRD system without a court order explicitly directing the expungement.<sup>31</sup>

Since imposing the moratorium in 1999, FINRA has required a two step process when a broker seeks to expunge customer dispute information through the arbitration process. First, the broker must request that the arbitrator direct or recommend expungement of the customer dispute information from the broker’s CRD.<sup>32</sup> Then, the broker must confirm the

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25. “[C]ustomer Dispute Information” includes ‘customer complaints, arbitration claims, and court filings made by customers, and the arbitration awards or court judgments that may result from those claims or filings. This category of information contains allegations that a member or one or more of its associated persons has violated securities laws, regulations, or rules.’” Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc., Exchange Act Release No. 47,435, 79 SEC Docket 2123, at 3 (Mar. 4, 2003).

26. This removes the record of the dispute from BrokerCheck as well because BrokerCheck gets its information from the CRD system.

27. See NASD Notice to Members 99-09, 1999 WL 33176491 (Feb. 1999), available at <http://www.finra.org/Industry/Regulation/Notices/1999/P004579>.

28. NASAA Comment Letter from Joseph Borg, 2001 President of NASAA, to Barbara Sweeney, Office of Corporate Secretary, NASD, in response to NASD Notice to Members 01-65, <http://www.nasaa.org/wp-content/uploads/2011/07/95-Letter.37262-47637.pdf> (Jan. 6, 2003).

29. Exchange Act Release No. 47,435, 79 SEC Docket 2123, at 3 (Mar. 4, 2003).

30. *Karsner v. Lothian*, 532 F.3d 876, 885 n.9 (D.C. Cir. 2008) (emphasis in original).

31. Exchange Act Release No. 47435, 79 SEC Docket 2123, at 1 (Mar. 4, 2003).

32. Oftentimes in the arbitration award, the arbitrator “recommends expungement.” As will be discussed in further detail below, courts differ on whether this is a directive of

arbitration award in a court of competent jurisdiction before FINRA will expunge the information from the CRD system.<sup>33</sup> At about the same time, FINRA conducted a thorough review of its expungement procedures. In 2002, it proposed adopting NASD Rule 2130 to govern the expungement of customer dispute information from the CRD system. In the proposed rule, FINRA sought to balance three competing interests:

- (1) the interests of [FINRA], the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.<sup>34</sup>

Foreseeing issues to come, FINRA stated that it was “cognizant of the importance of ensuring that the expungement policy does not have an overly broad chilling effect on the settlement process or inappropriately interfere with the arbitration process or arbitrators’ authority to award appropriate remedies.”<sup>35</sup>

The SEC approved NASD Rule 2130 in December 2003. The rule codified the requirement that an arbitration award directing the expungement of customer dispute information be confirmed by a court of competent jurisdiction. The rule further required that FINRA be named as a party to the confirmation proceeding unless it waived the requirement. Pursuant to the rule, a broker would not be required to name FINRA as a party if certain requirements were met:

- (1) Upon request, [FINRA] may waive the obligation to name [FINRA] as a party if [FINRA] determines that the expungement relief is based on affirmative judicial or arbitral findings that:
  - (A) the claim, allegation or information is factually impossible or clearly erroneous;
  - (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or
  - (C) the claim, allegation, or information is false.
- (2) If the expungement relief is based on judicial or arbitral findings other than those described above, [FINRA], in its sole discretion and under extraordinary cir-

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expungement. Notice to Arbitrators and Parties on Expanded Expungement Guidance, FINRA, <http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/expungement/> (last visited Mar. 19, 2014).

33. *Id.*

34. Exchange Act Release No. 47435, 79 SEC Docket 2123, at 4 (Mar. 4, 2003).

35. *Id.*

cumstances, also may waive the obligation to name [FINRA] as a party if it determines that:

(A) the expungement relief and accompanying findings on which it is based are meritorious; and

(B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.<sup>36</sup>

This rule contemplates that FINRA may have a role in the broker's request to confirm an arbitration award that contains an expungement directive. Additionally, it was contemplated that the state regulators (in the states where the broker was registered) would also be notified whenever a broker sought FINRA waiver under the rule, and that the state regulators would have an opportunity to petition the court to intervene at the confirmation stage.<sup>37</sup> As will be discussed in further detail below, the state regulators have met with mixed success when they have attempted to do this.

In 2009, NASD Rule 2130 was adopted as part of the Consolidated FINRA Rulebook as FINRA Rule 2080.<sup>38</sup> Importantly, this Rule falls within the "Duties and Conflicts" section of the FINRA Rulebook but not within the "Code of Arbitration Procedure for Customer Disputes" section. Indeed, until 2008, the Code of Arbitration Procedure did not even address expungement of customer dispute information. Arbitrators and parties operated without any guidelines or rules governing the arbitrators or their consideration of expungement requests. Moreover, because arbitration awards are not precedential and generally do not explain their reasoning, parties could not even find much guidance in past awards. NASD Rule 2130 only governed the process of confirming an arbitration award containing an expungement directive.<sup>39</sup> Its existence at least validated that arbitrators could direct expungement and suggested that expungement might be appropriate in the circumstances covered by NASD Rule 2130(1).

To provide guidance to parties and arbitrators, in March 2008, FINRA filed a proposed rule change with the SEC to adopt FINRA Rule 12805 to establish procedures for arbitrators considering expungement requests.<sup>40</sup> The

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36. FINRA, NASD Rule 2130(b), *available at* [http://finra.complanet.com/en/display/display.html?rbid=2403&element\\_id=3615](http://finra.complanet.com/en/display/display.html?rbid=2403&element_id=3615) (Apr. 2013).

37. National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment, Exchange Act Release No. 48,933, 81 SEC Docket 2659, at 2, 7 (Dec. 16, 2013).

38. See FINRA, Regulatory Notice 09-33, 2009 WL 1701937 (June 15, 2009), *available at* <http://www.finra.org/Industry/Regulation/Notices/2009/P118968>.

39. As discussed above, confirmation of the arbitration award is a necessary step in having the information ultimately expunged from the CRD system.

40. See Exchange Act Release No. 58,886, at 2

SEC approved the Rule on October 30, 2008.<sup>41</sup> Under Rule 12805, arbitrators must do the following before granting an expungement request:

- (a) Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This paragraph will apply to cases administered under Rule 12800 even if a customer did not request a hearing on the merits.
- (b) In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of a settlement.
- (c) Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case.
- (d) Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.<sup>42</sup>

In its discussion about the need for the rule proposal, FINRA commented that, in the case of settlements, it had expected arbitrators to review the terms and conditions of settlement, including the amount paid, before granting expungement.<sup>43</sup> Because arbitrators were not inquiring into the terms of settlement, FINRA adopted the rule to provide more guidance.<sup>44</sup> FINRA viewed this change as “part of its ‘continuing effort to ensure that arbitrators evaluate fully each request for expungement.’”<sup>45</sup>

Yet the new guidance in Rule 12805 did not cover all situations where a broker might legitimately seek to expunge a customer complaint from his or her record. Although FINRA Rule 12805 explains how *parties* to arbitration may seek expungement, BrokerCheck also discloses customer dispute information even if the broker is not a party to the arbitration. For example, in certain cases a broker may be the subject of allegations of sales practice violations made in an arbitration claim but not named as a party to the arbitration. In such a case, the information about the arbitration claims is reportable on the broker’s CRD record pursuant to questions 14I(4) and (5) of the Form U4 as discussed above.<sup>46</sup>

To address this issue, FINRA is now considering how to implement appropriate procedures for brokers to seek expungement in cases where the broker is not a party to the arbitration. In this vein, in April 2012, FINRA

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41. *Id.* at 1.

42. Rule 12800 is the Simplified Arbitration Rule. Pursuant to Rule 12800, no hearing may be held unless the customer requests one. Rule 12805 modifies the rule to permit a hearing to be held for the limited purpose of determining the expungement issue.

43. *See* Exchange Act Release No. 58,886, at 2.

44. *Id.* at 6.

45. *Id.*

46. *See* FINRA Regulatory Notice 12-18, 2012 WL 1150749 (Apr. 5, 2012), available at <http://www.finra.org/Industry/Regulation/Notices/2012/P125948>.

sought comment on proposed *In re* expungement procedures.<sup>47</sup> The proposed *In re* expungement procedures would provide a mechanism whereby a broker may seek to expunge customer dispute information if the broker is not a party to the arbitration. At present, no proposal has been filed with the SEC because FINRA continues to consider the appropriate procedure.

## II. EXPUNGEMENT & SETTLEMENT

In cases where the parties have settled their dispute, brokers often ask arbitrators to direct that information about the customer dispute be expunged from the broker's CRD record, often providing terms within the settlement agreement to facilitate that request. Over time, as the expungement process has changed, the customer's role in that process has changed as well. Customers have never had the ability to grant a broker's expungement request. Prior to the enactment of NASD Rule 2130, there was no requirement that arbitrators make any kind of affirmative finding before granting an expungement request. In the case of settlements, brokers would often seek the cooperation of customers in the preparation of stipulated awards. The parties would place a stipulated award before the arbitrators containing an expungement directive, which the arbitrators would then sign. The broker would then confirm the award in a court of competent jurisdiction either with the consent of the customer or by default if the customer did not appear.

### A. Customer Affidavits

NASD Rule 2130 began to change the landscape because the arbitrators were required to make an affirmative finding of fact supporting the expungement request or the broker risked FINRA objecting to the expungement directive at the confirmation stage. Brokers continued to seek the cooperation of customers in the process to varying degrees. Indeed, many customers may have been pressured to make untrue statements as a condition of settlement. After enacting Rule 2130, FINRA discovered that brokers were seeking customer affidavits to support their expungement requests.<sup>48</sup> Specifically, there were instances where respondents (brokers and firms) would procure customer affidavits absolving one or more of the respondents of wrongdoing in exchange for monetary compensation.<sup>49</sup> The affidavits appeared to be "inconsistent on their face with the initial claim

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47. *See id.*

48. *See* NASD Notice to Members 04-43, 2004 WL 1238021, at 554 (June 2, 2004), available at <http://www.finra.org/Industry/Regulation/Notices/2004/P003014>.

49. *Id.*

and terms of the settlement.”<sup>50</sup> FINRA cautioned its members that, if they used affidavits containing information that was bargained for, rather than the truth, they might be subject to sanctions and other penalties, including possible criminal sanctions for subornation perjury.<sup>51</sup>

Although brokers may not ask a customer to affirmatively state that a basis for expungement exists if that is not the truth, brokers often request that customers not oppose a request for expungement in connection with a settlement. This has not been addressed by FINRA rule nor by FINRA guidance through interpretive memos or notices to members. This should not impact the outcome of the expungement request because, as discussed above, the broker must establish that he has satisfied one of the grounds set forth in FINRA Rule 2080 and therefore, the burden of proof rests squarely on the broker.

## B. Arbitrator Findings

The arbitration panel must make an affirmative finding of fact to support its expungement directive, even if the broker and the customer have settled the case. FINRA appears to have contemplated that, once a claim is settled, customers will not participate in the expungement process; however, that does not change the fact that the broker must still meet the rule’s burden of proof. When FINRA proposed Rule 2130, it responded to concerns that brokers would buy clean records as a part of the settlement process:

[FINRA] responded to this concern in Amendment No. 2 by asserting that the “affirmative determination” requirement imposed on arbitrators should foil attempts to “buy a clean record.” Under the proposed standard, dismissal of a claim alone would not be a sufficient basis for ordering expungement. [FINRA] states that its arbitrator training materials will make clear that an expungement order must be premised on an *affirmative determination* by the arbitrator that the respondent was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Without such an *affirmative finding*, [FINRA] would have no basis under this standard to waive its obligation to be named as a party in the court confirmation process.<sup>52</sup>

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50. *Id.*

51. *Id.* In a footnote, FINRA cautioned individuals who were not subject to FINRA jurisdiction that they may also be subject to sanctions from the arbitration panel, law enforcement agencies, state bar associations or other attorney disciplinary bodies, among others. *Id.*

52. Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No.2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, Exchange Act Release No. 48,933, 81 SEC Docket 2659, at 5 (Dec. 16, 2003).

In its proposal to adopt FINRA Rule 12805, the absence of the customer at the expungement hearing was discussed and dismissed as a concern:

Argument 2: If customer claimants do not participate in the expungement hearing, arbitrators will hear only the requesting party's position.

Response: FINRA noted that under the proposal, customers will continue to have the opportunity to attend and participate in expungement hearings in person or via telephone, and the customer may submit a written statement if he chooses not to participate or attend in person. In addition, FINRA vowed to take measures to ensure that arbitrators are prepared to perform the critical fact-finding that is required by the rule proposal, whether or not a customer is present at the hearing.<sup>53</sup>

In the arbitrator training material on expungement, arbitrators are told that they must conduct fact finding even if there has been a settlement:

Before ordering expungement following a settlement, arbitrators are required to review the settlement documents, consider the amount paid to any party, and consider any other terms and conditions of the settlement that might raise concerns about the associated person's involvement in the alleged misconduct before awarding expungement. In order for arbitrators to perform this critical fact finding before granting expungement, Rules 12805 and 13805 require arbitrators to hold a recorded hearing session by telephone or in person. The requirement of a hearing session ensures that arbitrators consider the facts that support or weigh against a decision to grant expungement.<sup>54</sup>

Lastly, in its proposal to adopt *In re* proceedings, FINRA stated that "the absence of a party at the *In re* expungement proceeding would not create a presumption that the absent party either consents to or opposes the expungement request."<sup>55</sup>

In October 2013, FINRA issued supplemental guidance to arbitrators and parties regarding expungement.<sup>56</sup> FINRA once again stated that expungement is an extraordinary remedy.<sup>57</sup> In addition, FINRA highlighted the specific role the arbitrator is expected to have in the expungement process:

Arbitrators have a unique, distinct role when deciding whether to grant a request to expunge information from a broker's CRD record. In making these determinations, arbitrators should consider the importance of maintaining the integrity of the in-

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53. See Exchange Act Release No. 58,886, at 3.

54. See FINRA DISPUTE RESOLUTION EXPUNGEMENT 19 (April 2011), available at <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p125419.pdf>.

55. See FINRA Regulatory Notice 12-18, at 7.

56. Notice to Arbitrators and Parties on Expanded Expungement Guidance, FINRA, <http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/expungement/> (last visited Feb. 4, 2014).

57. *Id.*

formation in the CRD system. Ensuring that CRD information is accurate and meaningful is essential to investors, who may rely on the information when making decisions about brokers with whom they may conduct business; to regulators, who rely on the information to fulfill their regulatory responsibilities; and to prospective broker-dealer employers, who rely on the information when making hiring decisions.

Given this significant role, arbitrators should ensure that they have all of the information necessary to make an informed and appropriate recommendation on expungement. Thus, arbitrators should request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle before an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing.<sup>58</sup>

Notwithstanding the significant training and guidance by FINRA, it appears that arbitrators may not fully understand the proof necessary to support a finding that expungement is appropriate. One arbitration decision went to great lengths to discuss the standards that should be applied by arbitrators when deciding if a claim is false: “When an allegation is supported by some reasonable proof, even short of ‘preponderance,’ it cannot be said to be ‘false.’ Unfortunately, too many decisions improperly label claims as ‘false’ simply because they were not supported by a preponderance of the evidence.”<sup>59</sup> As discussed above, FINRA has stated that dismissal of a claim is not a sufficient basis for granting expungement. It is clear that much more is needed to justify such a significant remedy, yet often very little support is offered in the arbitration awards.

### III. PUBLIC INTEREST CONCERNS

The current expungement system leaves much to be desired and does not adequately serve the public interest. As explained below, the states have experienced a mix of successes and failures when attempting to voice concerns about particular expungements. Despite the efforts of a few state regulators in a small number of cases, a recent study reveals that expungements may have moved from extraordinary remedies to a normally bargained for benefit in case settlements. As a result, the CRD system no longer contains complete and accurate information.

#### A. State Regulator Intervention

Although FINRA has made efforts to improve its expungement processes, state regulators have sought a greater voice in the process. As

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58. *Id.*

59. *In re Arbitration between Gilliam v. SagePoint Fin., Inc.*, 2013 WL 3963949, at \*2 (July 19, 2013) (Meyer, Arb.). This award contains a multi-page detailed explanation of the arbitrator’s consideration of the expungement request.



discussed below, certain states have been especially active on this issue. Their efforts have not always been successful and there is cause to believe that state regulators should have a greater voice in the process at a much earlier stage when it can be meaningful.

a. *Maryland*

In 2007, the Maryland Securities Commissioner (the Commissioner) sought to intervene in a Petition to Confirm an Arbitration Award which contained an expungement directive in order to oppose the expungement of the broker's record.<sup>60</sup> The customer had received \$47,000 in settlement in exchange for stipulating to the expungement of all references to the dispute from the broker's CRD record.<sup>61</sup> The arbitrators had approved the stipulated award which had been submitted to them, and had recommended the expungement of the broker's CRD record.<sup>62</sup> In accordance with Rule 2130, the broker then filed a petition to confirm the stipulated award in the United States District Court for the District of Columbia and named FINRA as a party to the action.<sup>63</sup> FINRA notified NASAA that such a petition had been filed, and NASAA in turn notified Maryland.<sup>64</sup> The Commissioner then sought to intervene in order to oppose the expungement of the broker's CRD.<sup>65</sup> The district court denied the Commissioner's motion to intervene, and, two days later, granted the petition to confirm the award.<sup>66</sup> The Commissioner filed a motion to reconsider the denial of the motion to intervene, which was also denied, and then appealed that decision to the Court of Appeals for the D.C. Circuit but did not appeal the lower court's confirmation of the arbitration award.<sup>67</sup> The Commissioner also sought a stay of the expungement of the broker's CRD pending the appeal in this case as well as eleven other cases where the broker was also seeking expungement.<sup>68</sup>

The D.C. Circuit examined whether the Commissioner had a right to intervene in the district court action. The court found that the Commissioner had a "legally protected interest in the action" because "Maryland has a recognized property interest in the CRD (pursuant to the agreement between NASAA and NASD and Maryland law)"; that "the action threaten[ed] to impair that interest" because the action "threatens to alter the CRD by

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60. See *Karsner v. Lothian*, 532 F.3d 876, 881 (D.C. Cir. 2008).

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* at 881-82.

expunging information about [the broker]; and that “no party to the action can be an adequate representative of the applicant’s interests” because “neither [the broker] nor [the customer] represents the Commissioner’s interest in protecting the integrity of the CRD.”<sup>69</sup> The D.C. Circuit reversed the lower court’s denial of intervention, and remanded the case for further proceedings in light of the fact that the Commissioner had not appealed the confirmation of the arbitration award.<sup>70</sup>

The D.C. Circuit also commented on the Commissioner’s argument that the lower court lacked authority to “confirm” the arbitrator’s expungement order because the order was not an arbitration award as understood by the Federal Arbitration Act. In this case, the arbitrator had merely “recommended expungement” of the broker’s CRD.<sup>71</sup> The D.C. Circuit agreed with the Commissioner, noting that Rule 2130 requires a broker to “obtain an order from a court of a competent jurisdiction...confirming an arbitration award *containing expungement relief*.”<sup>72</sup> The D.C. Circuit did not read the language “containing expungement relief” to apply to an arbitrator’s recommendation of expungement, and questioned whether the court could order expungement on the basis of the language in the stipulated award.<sup>73,74</sup>

b. *New York*

At about the same time the Commission was attempting to intervene in Maryland, the Attorney General also sought to intervene in a series of expungement requests pending in New York state court.<sup>75</sup>

The first case in which the Attorney General attempted to intervene was *Sage, Rutty & Co., Inc. v. Salzberg*.<sup>76</sup> The Attorney General was permitted to intervene, and opposed confirmation of the expungement portion of the award. This case is somewhat unique because the customer requested vacatur of the stipulated award, on the grounds that she entered the settlement agreement and signed the stipulated award under duress from

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69. *Id.* at 885–86.

70. *Id.* at 887.

71. *Id.* It is fairly common for an arbitrator to use the language “recommend expungement” when granting expungement relief to a broker in an arbitration award.

72. *Id.* (Internal quotations omitted, emphasis in original.)

73. *Id.*

74. It appears that the stay of the expungement in this case was lifted. The arbitration award which was confirmed, NASD Case No. 04-07347, does not appear on the broker’s, Joseph Karsner, BrokerCheck, although Karsner does have 31 other customer disputes disclosed. *Lothian v. Legacy Fin. Servs.*, NASD Case No. 04-07347 (Feb. 9, 2006) (Harris, Arb.).

75. In all but one case, the Attorney General was permitted to intervene.

76. No. 2007-01942 (N.Y. Sup. Ct. June 1, 2007).

her then-current attorney.<sup>77</sup> In its decision, the court described a conflict between FINRA's expungement Rule, finding that it promotes a type of judicial review of arbitration awards, and New York state law on vacating arbitration awards.<sup>78</sup> The court was troubled about the award, finding that the arbitrators' decision on expungement was irrational because it was made without any evidentiary support.<sup>79</sup> The court had no hearing, no written settlement agreement, and no other documents upon which it could rely in order to fulfill what the court believed was its responsibility under NASD rule 2130 to review the expungement award.<sup>80</sup> The court was also concerned that brokers could entice aggrieved investors to settle factually accurate claims by agreeing to a stipulated award recommending expungement, promoting private interests at the expense of the state's interest, as well as at the expense of the interests of potential investors and the public generally.<sup>81</sup> The court remanded the case to the arbitrators: "The Arbitrators are directed to clarify the facts and circumstances which led them to conclude [as they did in the Award] that 'the claim, allegation, or information is factually impossible or clearly erroneous.'"<sup>82</sup> After the arbitrators reissued their decision, the new award was confirmed by the court.<sup>83</sup>

In *Kay v. Abrams*, an arbitrator issued a stipulated award following a settlement, which provided for the expungement of the dispute from the broker's record. In considering the Attorney General's arguments for denying confirmation of the arbitration award, the NY court relied on a prior decision by the Second Department, which had been decided before the enactment of Rule 2130:

The Supreme Court erred in denying that branch of the petition which was to confirm the portion of the award which recommended expungement of the petitioners' public registration records. Judicial review of an arbitrator's award is extremely limited, and once an issue has been decided by an arbitrator, questions of law and fact are not within the power of the judiciary to review, as they are merged into the award. The Supreme Court, by confirming part of the award and denying the branch of the petition which was to confirm the portion of the award which recommended expungement, engaged in an impermissible modification of the award

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77. See Timothy A. Canning, *Cases & Materials*, 14 PIABA B.J 71, 87-88.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* The court rejected the customer's claim of duress, finding that there was no evidence that she signed the stipulated award against her free will. *Id.*

83. The motion to confirm the arbitration award was granted on December 20, 2007. See *WebCivil Supreme*, NEW YORK STATE UNIFIED COURT SYSTEM, <https://iapps.courts.state.ny.us/webcivil/FCASSearch?param=I> (last visited February 13, 2004) (enter "01942/2007" into "Index Number" search field; then click on the result "SAGE, RUTTY & CO, INC." and click on "Show Motions" box in lower, right-hand corner. Motion Number 003 indicates that the motion to confirm the arbitration award was granted).

that affected the substantive rights of the parties. Moreover, the arbitration award was based upon the stipulation of the parties. Stipulations of settlement are favored by the courts and will not be set aside on facts less than needed to avoid a contract, e.g., fraud, overreaching, mistake, duress, or some other ground of similar nature. At no time was the parties' stipulation challenged on these or any other grounds. The Supreme Court therefore improperly substituted its own judgment for that of the parties when it denied that branch of the petition which was to confirm the portion of the arbitration award which recommended expungement of the petitioners' public registration records.<sup>84</sup>

Because the court could not find any basis for not confirming the arbitration award, it denied the Attorney General's motion to intervene as moot.<sup>85</sup>

The Attorney General successfully intervened in the remaining five cases. In two, the same judge was considering the petitions to confirm the arbitration awards and consolidated the cases for purposes of review.<sup>86</sup> In its discussion of the history of the expungement process, the court recognized the state's role in the process.<sup>87</sup>

Hence, member firms and individuals seeking expungement of matters arising out of a customer claim are bound by Rule 2130, which limits the arbitrator's authority to award expungement relief. If an arbitrator recommends expungement of customer complaint information from the CRD, the affected firm or individual must also obtain court confirmation. In all such cases, regardless of NASD's decision to participate, regulators of any state in which the member is registered may appear in the court proceeding to oppose expungement or to present other public policy considerations to the court.

The facts underlying the two arbitrations were different. In the Summit Equities case, the underlying dispute was settled, and a stipulated award was submitted to the arbitration panel for its consideration.<sup>88</sup> The arbitration panel held a telephonic hearing with counsel for the parties on the issue of expungement, and received an affidavit from the broker.<sup>89</sup> The arbitration panel issued an award recommending expungement based upon

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84. 853 N.Y.S.2d 862, 866-67 (Sup. Ct. 2008) (quoting *Goldstein v. Preisler*, 805 N.Y.S.2d 647, 647 (App. Div. 2005)).

85. *Id.*

86. The two cases consolidated were *In re Arbitration between Johnson v. Summit Equities, Inc.*, No. 104034/2007 (N.Y. Sup. Ct. 2007) and *In re Arbitration between UBS Fin. Servs. Inc. v. Gibson*, No. 103188-2007 (N.Y. Sup. Ct. Nov. 15, 2007).

87. *In re Johnson*, 864 N.Y.S.2d 873, 881 (Sup. Ct. 2008) (citing Self-Regulatory Orgs., Nat'l Ass'n of Sec. Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information from the Central Registration Depository System, 68 Fed. Reg. 74667, 74671 n. 30).

88. *Johnson*, 864 N.Y.S.2d at 882-83.

89. *Id.* at 883

one of the grounds set forth in Rule 2130.<sup>90</sup> In the UBS case, the underlying dispute did not settle. A contested arbitration hearing was held before a single arbitrator.<sup>91</sup> In the award, the arbitrator dismissed the claims and recommended expungement of the broker's record.<sup>92</sup>

In discussing the standards for reviewing arbitration awards, the court found that it "may not substitute its own factual findings or legal conclusions for those of the arbitrator, even when it believes the arbitrator's interpretation of the law was erroneous."<sup>93</sup> However, the court found that "statutes or regulations applicable to a particular field may establish additional requirements to be met by arbitrators in rendering their awards, thereby creating additional grounds for modification or vacatur by reviewing courts...Rule 2130 and its accompanying scheme is such a regulation."<sup>94</sup>

The rule required the awards to contain affirmative factual findings, however, because the language in the awards were simply a recitation of the language within Rule 2130, the awards did not contain affirmative factual findings.<sup>95</sup> Moreover, the court read Rule 2130 as *requiring* judicial review of the arbitral record.<sup>96</sup> The court pointed to language within the SEC approval of Rule 2130, finding that both the NASD and the SEC "adopted a requirement of an independent judicial review and confirmation as a precondition to expungement by the NASD."<sup>97</sup> Because there was not a sufficient record in either case, the court remanded both to the original arbitrators to provide "amended awards containing specific affirmative factual findings in each case justifying the expungement recommendations, along with the portions of the record on which those findings are based, in sufficient detail to enable this court to conduct a meaningful, albeit limited, judicial review as required by Rule 2130."<sup>98,99</sup>

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90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 888

94. *Id.*

95. "Furthermore, repetition in these awards of the language from Rule 2130 can in no sense be considered a finding which is 'affirmative.' In the absence of any reference at all to the specific facts of the case, the determination is devoid of any affirmative factual finding." *Id.* at 892.

96. *Id.* at 896.

97. *Id.*

98. *Id.* at 901.

99. In *In re Arbitration between UBS Fin. Servs., Inc. v. Gibson*, the Revised Arbitration Award, dated June 15, 2009, was eventually confirmed on November 17, 2009. It does not appear that the Attorney General appeared when the Revised Arbitration Award was submitted for confirmation. References to this arbitration no longer appear on the broker's, Karen Kurrasch, Brokercheck. See *WebCivil Supreme*, NEW YORK STATE UNIFIED COURT SYSTEM, <https://iapps.courts.state.ny.us/webcivil/FCASSearch?param=I> (last visited

In the remaining three cases where the Attorney General was permitted to intervene, the court confirmed each of the arbitration awards. In the first of the decisions, the Attorney General argued that “expungement would hinder its ability to bring proceedings against brokers or securities dealers who act contrary to the law.”<sup>100</sup> The court relied on the analysis of the law set forth in *Kay v. Abrams*, finding that “there is not public policy against expungement.”<sup>101</sup> In contrast to the court in the two cases discussed above, this judge was not troubled by the arbitrator not giving a reason for the decision, stating “it is well established that there is no requirement for an arbitration award to state its reasoning.”<sup>102</sup> Accordingly, the court confirmed the arbitration award.<sup>103</sup>

In the second case, the Attorney General once again argued that the court could perform a meaningful review of the award because the arbitration panel had merely tracked the language with Rule 2130 when it made its recommendation of expungement in the arbitration award.<sup>104</sup> This case differed slightly from the *Summit Equities* case because the customer settled the case with the broker and the firm two years before the broker made the request for the expungement.<sup>105</sup> The court specifically found that “this is not a case in which a private claimant had an incentive to agree to expungement in order to obtain a settlement payment. Rather, claimant agreed to the expungement, without any additional compensation, two years after the settlement was paid.”<sup>106</sup> Because of these facts, the court found that the confirmation of the award was not against public policy.<sup>107</sup> Finding no other basis to support any challenge to the confirmation, the court confirmed the arbitration award.<sup>108</sup>

In the last case, the Attorney General offered several grounds in opposition of confirmation; (1) “the panel ‘exceeded its authority’ by failing to provide a factual basis for its recommendation of expungement;” (2) “a stipulated award providing for expungement without explanation, is against public policy;” and (3) “the panel’s recommendation of expungement is not

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February 15, 2004) (enter “103188/2007” into “Index Number” search field; then click on Option 1 and click on “Show Decisions” box in lower, right-hand corner. Motion Number 3 indicates that the award was confirmed on November 17, 2009).

100. *Zaferiou v. Holgado*, No. 102996-2007, at 2 (N.Y. Sup. Ct. Oct. 22, 2007).

101. *Id.*

102. *Id.*

103. *Id.* at 3.

104. *BNY Inv. Ctr., Inc. v. Bacchus*, Index No. 109678/2007, at 2 (N.Y. Sup. Ct., N.Y. County June 13, 2007).

105. *Id.* at 4.

106. *Id.* at 5.

107. *Id.*

108. *Id.* at 6.

an ‘award’ subject to confirmation.”<sup>109</sup> The arguments made by the Attorney General with respect to the first two grounds were similar to those made in the other cases. In this case, the arbitrators had conducted a telephonic conference, and received a combined affidavit by the brokers, and Stipulated Factual Particulars which had been signed by counsel for the customer, and counsel for the brokers and the brokerage firm.<sup>110</sup> The court held that this provided a sufficient factual basis for the arbitration panel’s conclusions within the arbitration award regarding expungement.<sup>111</sup> Accordingly, the arbitrators had not exceeded their authority. The Attorney General attempted to also make the argument that the recommendation of expungement was not an “award”, based on the Karsner decision.<sup>112</sup> The court found that, because the recommendation of expungement is part of the “Award”, it was properly before the court.<sup>113</sup> The court also found no basis for the Attorney General’s argument that confirmation of the award would be contrary to public policy.<sup>114</sup> The award was confirmed.<sup>115</sup>

#### B. PIABA’s Expungement Study

In October 2013, PIABA, the Public Investors Arbitration Bar Association, issued a study which examined arbitrator ordered expungements following settlements (the “Study”). The Study found:<sup>116</sup>

- An “alarmingly” high percentage of arbitration cases resolved by settlement or stipulated awards where expungement relief has been granted. For the time period January 1, 2007 through mid-May 2009, expungement was granted in 89 percent of the cases resolved by stipulated awards or settlement. (The May 2009 end date reflects a change in reporting requirements mandating more information about arbitration cases.)
- For the most recent time period mid-May 2009 through the end of 2011, expungement relief was granted in nearly every instance -- 96.9 percent of the cases resolved by settlements or stipulated awards.

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109. *In re Arbitration between Walker v. Connelly*, 873 N.Y.S.2d 516, 516 (Sup. Ct. 2008).

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* References to the underlying arbitration have been removed from both of the brokers’, Wayde Walker and Nathaniel Clay, BrokerChecks. However, relevant motions and decisions for the arbitration are available at *WebCivil Supreme*, NEW YORK STATE UNIFIED COURT SYSTEM, <https://iapps.courts.state.ny.us/webcivil/FCASSearch?param=I> (last visited February 15, 2004) (enter “100681/2008” into “Index Number” search field; select the first result).

116. See Press Release, PIABA Study: Stockbroker Arbitration Slates Wiped Clean 9 out of 10 Times When “Expungement” Sought in Settled Cases (Oct. 16, 2013), available at <https://piaba.org/system/files/pdfs/PIABA%20Expungement%20Study.pdf>.

PIABA chose to split the time period as of May 2009 to reflect the changes made to the Form U4, and the inclusion of Question 14I(4) and (5) discussed above, which required the disclosure of arbitration claims regardless of whether the broker was named as a party to a claim. The results of the PIABA study demonstrate that, following settlement, expungement is granted frequently, notwithstanding the high burden on brokers to establish one of the grounds set forth in FINRA Rule 12805. The Study also found that certain brokers obtained expungement repeatedly. One individual associated with a brokerage firm requested expungement 40 times, and arbitration panels granted such relief to that individual 35 times.<sup>117</sup>

The Study demonstrates that arbitrators routinely find that expungement is an appropriate remedy following settlement of the underlying dispute notwithstanding FINRA's repeated admonishment that it should be extraordinary. It strains credibility that in almost every instance in which there was a settlement, the arbitrators were able to appropriately make "an *affirmative determination* ... that the respondent was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds."<sup>118</sup> It appears that the arbitrators either are not following the instructions provided or do not understand the appropriate bases under which expungement should be ordered.

PIABA made a number of recommendations to help remedy the problems it identified. PIABA suggested that FINRA make it a rule violation for a broker or firm to bargain for expungement in the settlement process, including for a broker to request that a customer not oppose a request for expungement.<sup>119</sup> PIABA suggested that FINRA improve arbitrator training to stress the importance of the CRD system, and provide greater oversight of the process the arbitrators go through when considering an expungement request.<sup>120</sup> PIABA called for greater involvement by FINRA in the expungement process itself, requesting that when an expungement request follows a settlement, FINRA also reviews the settlement documents.<sup>121</sup> PIABA also suggested that state securities administrators be provided with notice that a broker has made a motion for expungement relief to an arbitrator and be given the opportunity to appear at the hearing and oppose the request if appropriate.<sup>122</sup>

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117. *Id.*

118. See Exchange Act Release No. 48,933, at 5.

119. Press Release, *supra* note 116, at 26.

120. *Id.* at 26-27.

121. *Id.* at 27.

122. *Id.* at 27-28.



## IV. RECOMMENDATIONS FOR CHANGE AND CONCLUDING REMARKS

Expungement of customer dispute information from the CRD remains an extraordinary remedy. It should only be used “when the expunged information has no meaningful regulatory or investor protection value.”<sup>123</sup> It is important that this concept be embraced in practice as well as principle.

FINRA should continue its efforts to remove expungement entirely from the settlement process. FINRA took the first step in this direction when it cautioned firms against bargaining for fraudulent affidavits to support expungement requests. More often, brokers and their firms are now requiring that customers not oppose expungement requests as part of the settlement process. This behavior on the part of the brokers and the firms impedes the arbitrators’ ability to fulfill their role in this process and may have broader implications with respect to the integrity of the CRD system. FINRA has contemplated that customers may choose not to participate in the expungement hearing, and educates its arbitrators with respect to their responsibilities. However, FINRA does not appear to have addressed the fact that brokers and firms use the settlement process to chill customer participation in expungement hearings. It remains important that the arbitrators receive effective training so that they fully understand the significance of an expungement request. However, if a customer wishes to assist in the process, they should be permitted to do so and firms and brokers should be prohibited from preventing that from happening. Adoption of a rule which would prohibit settlement conditioned on a customer’s nonparticipation in an expungement request may improve the process.

Expungements continue to be too readily granted by arbitrators. This does not appear to be solely a result of customers not opposing the expungement requests because they have settled their claims. This is more likely a result of arbitrators not fully understanding the standards pursuant to which expungements should be granted. In each case, the factual basis offered appeared to be the result of a weighing of the sufficiency of the evidence, not the falsity (or frivolity) of the claims. As discussed above, a false claim requires more than a finding that the claims were not supported by a preponderance of the evidence. Arbitrators should not be granting expungement requests based upon the insufficiency of the evidence presented regarding the allegations made in the arbitration claim. Customers do not have a burden of proof that must be met when a broker makes a request for expungement – the broker bears that burden. A customer’s failure to adequately prove their case does not create a basis for expungement.

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123. See Exchange Act Release No. 58,886, at 6.

Given the high number of expungements requests granted following settlements, when customers do not appear at the expungement hearing, indicates that arbitrators do not fully understand the burden of proof necessary to justify the granting of an expungement request. Perhaps the arbitrators are not fully complying with the training provided by FINRA and are not giving full weight to the amount of money that had been paid in the settlement, or the terms of the settlement agreement which specifically provides for the customer's nonappearance. Perhaps the arbitrators treat the customer's non-appearance akin to a default and feel they must grant the broker's request for expungement because there has been no opposition.

FINRA has conducted extensive arbitrator training on expungement since the rules were first enacted. It is clear the training is not sufficient to ensure the rules will be followed. FINRA must be involved in the process to ensure that the arbitrators are following the rules. FINRA case administrators may observe expungement hearings to ensure that proper procedure has been followed. FINRA may adopt arbitrator scripts which re-emphasize the extraordinary nature of the relief sought. FINRA may also adopt rules which penalize brokers and firms for making frivolous requests for expungement when there is simply no possible basis for the remedy.

It is important that FINRA ensure that requests for expungement are thoroughly examined prior to the issuance of an arbitration award. As discussed above, state regulators have almost no ability to challenge confirmation of an arbitration award containing an expungement directive. Once the award has been issued, it is too late to do anything about it. It is unlikely FINRA would have greater success if it sought to challenge confirmation of an arbitration award containing an expungement directive. Accordingly, FINRA must ensure that arbitrators only issue expungement directives in the very limited circumstances set forth in Rule 2080.

FINRA has a statutory obligation to ensure that the information it provides through BrokerCheck is accurate and complete. It can only meet that obligation if the expungement process is handled with integrity and if expungement is granted as a remedy only in extraordinary circumstances.